



OFFICES OF THE COUNTY EXECUTIVE

Isiah Leggett
County Executive

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May 11, 2007

Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended March 31, 2007. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of the Montgomery County Code.

History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. In addition to Montgomery County Government, participating agencies and subdivisions include the Montgomery County Revenue Authority, Housing Opportunities Commission of Montgomery County, independent fire/rescue corporations, Town of Chevy Chase, Strathmore Hall Foundation, Inc., Washington Suburban Transit Commission, Montgomery County Federal Credit Union, and certain employees of the State Department of Assessments and Taxation and the District Court of Maryland. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees. There were an estimated 5,250 active members and 4,870 retirees participating in the ERS as of March 31, 2007.

Performance Results

The total return achieved by the ERS assets for the quarter was a gain of 2.53%, 64 basis points ahead of the 1.89% gain recorded by the policy benchmark. For the one year period ending March 31, 2007 the ERS' gross return (before fees) was 11.84%, 60 basis points ahead of the 11.24% return of the policy benchmark and 3.84% above the 8% actuarial assumed return. The one-year return places the ERS' performance in the top 21% of a universe of public pension funds constructed by the Board's consultant, Wilshire Associates. For the three-year period, our annualized performance was 10.83%, before fees, ranking in the top 27% of the universe. The asset allocation at March 31, 2007 was: Domestic Equities 45.3%, International Equities 20.5%, Fixed Income 21.4%, Inflation Linked Bonds 8.7%, Alternative Investments 3.4%, Real Estate 0.5% and Cash 0.2%.

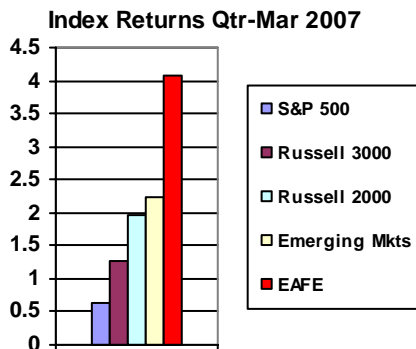
Major Initiatives

During the quarter, the Board approved a new strategic asset allocation for the ERS, which included establishing three dedicated asset buckets: equities, fixed income and real/inflation hedge assets; increasing allocations to private equity and real estate; and introducing other investments such as commodities, absolute return and long duration strategies. The changes will result in further diversifying the ERS investment portfolio by adding new investment strategies, better managing the total portfolio's risk and increasing the investment return. A gradual rebalancing of assets and implementation of possible new investment strategies will take place over the next several years. In addition, the Board approved the hiring of three third-party transition managers to form a pool which will be used to evaluate and conduct future ERS portfolio transitions.

The Board approved and requested the County Executive transmit legislation to the County Council which would expand the universe of investments available and conform to new State legislation and the recently passed Federal Pension Protection Act of 2006.

Capital Markets and Economic Conditions

2006 was a year of limited volatility in global capital markets, leading to almost universally strong equity market returns. 2007 started in similar fashion, although the first quarter ended with greater economic fears on the horizon. In the housing market, subprime mortgage lenders became the big focus of attention and brought worries about a housing-induced recession to the forefront. With the concerns facing the sub-prime market, there was a spread of credit concern and a potential credit 'crunch' among high-risk borrowers targeted by the subprime market. In addition, non-housing related economic data also seemed to trend lower during the quarter. As well as the domestic economic concerns, a 9% daily decline by the Chinese stock market precipitated a worldwide market correction at the end of February, with the 3.5% fall in the US being the largest one day decline since September 11th.

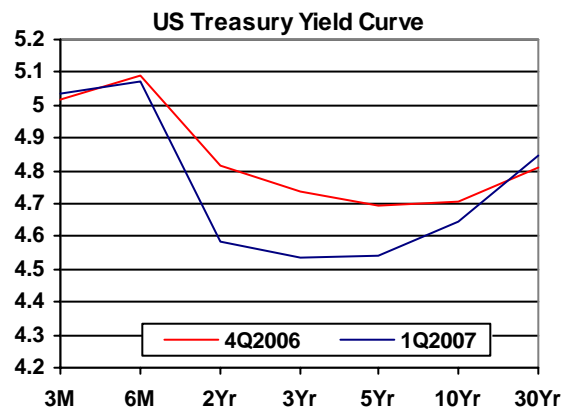


The U.S. equity markets continued to post positive returns despite the increased volatility during the first quarter driven by a sharp decline in China's local markets and by concerns on the growing levels of defaults in the sub-prime loan market. As shown in the chart to the left, the smaller capitalization firms (as represented by the Russell 2000 Index) continued to outperform large capitalization companies (as represented by the S&P 500 Index). The top performing sectors of the S&P 500 during the quarter were basic materials and utilities while financials were the worst performing sector. Our combined domestic equity performance was a gain of 2.10%, 83 basis points ahead of the Russell 3000

benchmark index return, driven by the strong performance of our small cap and large value managers. For the one year period ending March 31, our combined domestic equity performance was 11.9%, 68 basis points ahead of the 11.28% return achieved by the benchmark.

Within the international markets, developed international markets, as measured by the MSCI EAFE Index, were up 4.08% for the quarter with emerging markets increasing 2.25%. All EAFE markets except Ireland (-0.94%) posted positive returns with Finland and Singapore each returning over 10%. The markets of Peru (+24.96%) and Morocco (+24.70%) ranked among the top performing countries within the emerging markets sector. Our combined international equity performance was a gain of 4.84% (before currency managers' performance and 4.89% after), for the quarter, 109 basis points ahead of the benchmark index's return of 3.75%.

Interest rates were kept on hold during the first quarter, as the Fed held rates at 5.25%. The equity market correction at the end of February caused a 17 basis points decline in 2-year Treasuries yields. This reduction in yields, in the face of greater economic uncertainty, was maintained through to the end of the quarter and 2-5 year Treasury yields were significantly tighter-near the 4.50% mark. This steepening of the yield curve coincided with a minor change in stance by the Fed, due to their slight downgrading of current economic conditions. Elsewhere around the globe, there was a surprise tightening of interest rates in the UK in January, 25bps to 5.25%. As volatility increased due to the uncertainty, yield spreads on corporate bonds widened – in particular, high yield residential construction bonds widened by as much as 225bps. The ERS combined fixed income return for the quarter was a slight loss of -0.04% compared to 0.05% recorded by the benchmark index. Investments in inflation-linked bonds gained 0.28% for the quarter, 47 basis points ahead of the benchmark's negative return of -0.19%.



Additions

The primary sources of additions for the ERS include member and employer contributions and investment income. The following tables show the source and amount of additions for the quarter ending March 31, 2007 and fiscal year-to-date.

Employees' Retirement System Contributions and Investment Income (millions)

	Qtr 3/31/2007	Fiscal YTD
Employer Contributions	\$ 27.6	\$ 81.8
Member Contributions	4.1	12.3
Net Investment Income	60.3	291.9
	<u>\$ 92.0</u>	<u>\$ 386.0</u>

Deductions

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, and administrative expenses.

Employees' Retirement System Deductions by Type (millions)

	Qtr 3/31/2007	Fiscal YTD
Benefits	\$ 34.5	\$ 102.4
Refunds	0.3	0.6
Administrative Expenses	0.6	1.7
	<u>\$ 35.4</u>	<u>\$ 104.7</u>

Outlook

Following the market correction in February, the big concern is how the global economy will react. The first indications are positive – perhaps overly so – with the Chinese market not only recovering since the 9% decline, but racing ahead to add close to 30%. This leads to worries that the Chinese market is overheating and how any potential slowdown might impact other economies, particularly the U.S.

The main domestic concern continues to be housing with a particular focus on the impact of the subprime market. With signs of a credit 'crunch', what is currently only impacting a small part of the U.S. economy, might well escalate to credit concerns for prime borrowers as well as subprime. Recent home price escalation has seen a move towards adjustable rate mortgages and any lending rate spikes could negatively impact the cashflow of the U.S. consumer.

This leads to an uncertain time for fixed income as well as equities – Treasury yields may be tighter (due to a flight to quality from investors), but high yield spreads are negatively impacted. Private equity deals remain on the agenda, due to the current availability of credit and therefore we are seeing a larger proportion of borrowing on companies' balance sheets.

**EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF PLAN NET ASSETS**
March 31, 2007

Assets

Equity in pooled cash and investments	\$ 633,107
Investments:	
Northern Trust	2,574,872,818
Aetna	11,587,661
Fidelity - Elected Officials Plan	965,889
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Total Investments	2,587,426,368
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Contributions Receivable	4,952,861
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Total Assets	2,593,012,336
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Liabilities

Benefits payable and other liabilities	3,979,569
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Net assets held in trust for pension benefits	\$ 2,589,032,767
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EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS
 March 31, 2007

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	\$ 27,590,971	\$ 81,828,860
Member	<u>4,089,495</u>	<u>12,343,536</u>
Total Contributions	<u>31,680,466</u>	<u>94,172,396</u>
Investment Income	63,542,300	300,158,974
Less Investment Expenses	<u>3,244,715</u>	<u>8,264,274</u>
Net Investment Income	<u>60,297,585</u>	<u>291,894,700</u>
Total Additions	<u>91,978,051</u>	<u>386,067,096</u>
Deductions		
Retiree benefits	24,943,044	74,012,130
Disability benefits	8,104,677	23,968,011
Survivor benefits	1,494,774	4,438,691
Refunds	332,964	585,081
Administrative expenses	<u>591,769</u>	<u>1,709,978</u>
Total deductions	<u>35,467,228</u>	<u>104,713,891</u>
Net increase	<u>56,510,823</u>	<u>281,353,205</u>
Net asset held in trust for pension benefits		
Beginning of period	<u>2,532,521,944</u>	<u>2,307,679,562</u>
End of period	<u><u>\$ 2,589,032,767</u></u>	<u><u>\$ 2,589,032,767</u></u>